Cahill

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FTC Non-Compete Rule Update: Uncertainty Remains as Federal District Courts Issue Conflicting Preliminary Injunction Rulings

On July 3, 2024, the U.S. District Court for the Northern District of Texas, in a challenge to the validity of the Federal Trade Commission's (the "FTC") new non-compete rule, granted the plaintiffs' motion for a preliminary injunction and stayed the rule's effective date *as to the plaintiffs only*, concluding that the plaintiffs were likely to succeed in showing that the FTC overstepped its authority when issuing the non-compete rule. Subsequently, on July 23, 2024, in a similar challenge to the rule's validity, the U.S. District Court for the Eastern District of Pennsylvania denied the plaintiff's motion for a preliminary injunction to stay the rule's effective date, concluding that plaintiff was unlikely to succeed in challenging the non-compete rule and that plaintiff had failed to show that it would suffer irreparable harm absent an injunction. Subject to further judicial developments, the non-compete rule remains scheduled to come into effect for all parties other than the plaintiffs in the Texas case on *September 4, 2024*.

This memorandum addresses, in a question-and-answer format, recent judicial developments involving the FTC's non-compete rule, as well as several nuances and ambiguities employers should keep in mind when assessing employee non-competes and other restrictive covenants in the event the FTC's non-compete rule ultimately comes into effect.

Legal Challenges to the Rule

What is the current status of the legal proceedings?

Following the FTC's issuance of its final non-compete rule (the "Rule") on April 23, 2024,[1] multiple lawsuits have been filed challenging the validity of the Rule and seeking a preliminary injunction and stay of the September 4, 2024 effective date (the "Effective Date"). Ryan LLC, a tax services company, filed first in the U.S. District Court for the Northern District of Texas, and the U.S. Chamber of Commerce, along with other pro-business organizations, filed a similar suit a day later in the U.S. District Court for the Eastern District of Texas. The U.S. Chamber case has been stayed, and the plaintiffs have been allowed to intervene in the *Ryan* case.[2] Separately, ATS Tree Services, LLC filed a lawsuit challenging the Rule in the U.S. District Court for the Eastern District of Pennsylvania.[3] More

[1] See our memorandum, dated May 20, 2024, for an overview of the Rule.

[2] See *Ryan, LLC v. Federal Trade Commission*, Case No. 3:24-cv-00986 (N.D. Tex.); *Chamber of Commerce of the United States of America, et al. v. Federal Trade Commission*, Case No. 6:24-cv-00148 (E.D. Tex.) (Tyler Division). The plaintiff-intervenors consist of the Chamber of Commerce of the United States of America, Business Roundtable, Texas Association of Business and Longview Chamber of Commerce.

[3] See *ATS Tree Services, LLC v. Federal Trade Commission, et al.*, Case No. 2:24-cv-01743 (E.D. Pa.).

recently, Properties of the Villages, Inc., a residential community in Florida, filed another challenge to the Rule in the U.S. District Court for the Middle District of Florida.[4] The plaintiffs in these cases generally are asserting that the Rule is invalid because it (i) exceeds the FTC's statutory authority, (ii) is based on an unconstitutional delegation of Congressional authority, and/or (iii) is arbitrary and capricious. The lawsuit filed by Properties of the Villages also alleges that the Rule violates the U.S. Constitution's Commerce Clause, emphasizing that plaintiff's non-competes at issue "only temporarily restrict former Sales Associates from selling homes within a small area in central Florida" and therefore have no impact on interstate commerce.

As noted above, the Northern District of Texas court issued a preliminary injunction in *Ryan* and stayed the Effective Date as to the plaintiffs only. The court's rationale for limiting the injunction to the plaintiffs was based largely on the fact that the plaintiffs "offered virtually no briefing (or basis) that would support 'universal' or 'nationwide' injunctive relief."

What was the court's reasoning for granting a preliminary injunction in Ryan?

The court granted a preliminary injunction as to the plaintiffs because it concluded that plaintiffs had shown a likelihood of success in demonstrating that: (i) the FTC exceeded its statutory authority under the Federal Trade Commission Act (the "FTC Act") in promulgating the Rule and (ii) the Rule is arbitrary and capricious under the Administrative Procedure Act.

In ruling that the FTC exceeded its statutory authority, the court determined that Section 6(g) of the FTC Act does not empower the FTC to promulgate substantive rules about unfair methods of competition, but is rather limited to "housekeeping rules," i.e., interpretive or procedural rules. The court specifically noted that "the structure and the location of Section 6(g) show that Congress did not explicitly give the [FTC] substantive rulemaking authority under Section 6(g)."

In finding the Rule to be arbitrary and capricious, the court focused on the broad nature of the Rule's ban on non-competes. The court described the Rule as "unreasonably overbroad without a reasonable explanation" and a "one-size-fits-all approach with no end date." The court emphasized that the FTC failed to provide evidence explaining why it chose to impose a "sweeping prohibition," rather than taking a more targeted approach and that the FTC did not sufficiently consider alternative, and less-disruptive, approaches.

Why did the court in Ryan limit the preliminary injunction and only stay the Effective Date as to the named plaintiffs?

While the plaintiffs had sought a nationwide injunction, the court found that the plaintiffs had offered no briefing or basis to support nationwide injunctive relief, and, as it relates to the U.S. Chamber of Commerce, *et al*. as plaintiff-intervenors, the court emphasized that the "associational standing" argument had not been briefed, and therefore the court could not extend the injunction beyond the plaintiff-intervenors themselves. Since then, however, the parties have provided full briefing on the merits that includes the bases for a nationwide injunction. The court is scheduled to issue a final decision on the merits of the case by August 30, 2024, and it is therefore possible that the court will expand its ruling before the Rule's implementation.

Why did the court in ATS Tree Services deny the plaintiff's motion for a preliminary injunction and refuse to stay the Effective Date?

In sharp contrast to *Ryan*, the court in *ATS Tree Services* determined, based on its examination of the text and history of the FTC Act, that Section 6(g) provides the FTC with substantive rulemaking authority over unfair methods of competition. The court found that "the FTC is empowered to make both procedural and substantive rules

[4] See *Properties of the Villages, Inc. v. Federal Trade Commission*, Case No. 5:24-cv-000316 (M.D. Fla) (Ocala Division).

as is necessary to prevent unfair methods of competition." The court further rejected the plaintiff's arguments that the FTC lacked authority to issue the Rule by holding that the FTC is empowered under Section 5 of the FTC Act to "prevent" unfair methods of competition, which is "an inherently forward-looking directive, requiring the FTC to take action to avoid or avert a future occurrence in addition to remediating or stopping a past harm."

As to the plaintiff's constitutional argument, the court held that Congress had articulated an "intelligible principle" to guide the FTC and therefore properly delegated its authority.

Although the plaintiff had initially also challenged the Rule as arbitrary and capricious, it excluded this count from its preliminary injunction motion, and the court therefore did not address that claim at this stage of the proceedings. While the court did not formally address whether the Rule is arbitrary and capricious, it did tip its hand somewhat on this point, e.g., by describing the FTC's research and rule-making process for the Rule as "extensive" and "thorough."

Overview of the FTC's Non-Compete Ban

What does the Rule say about prohibiting non-competes?

The Rule provides that it is an unfair method of competition to enter into (or attempt to enter into), enforce (or attempt to enforce), or represent that a worker is subject to a "non-compete clause," subject to the sale of business and narrow senior executive exceptions discussed below. The Rule defines "non-compete clause" broadly to encompass any term or condition of employment that "*prohibits*," "*penalizes*," or "*functions to prevent*" a worker from seeking or accepting work in the United States that would begin after (or from operating a business after) the conclusion of an employment or service relationship.

As further discussed below, it is clear from the FTC's commentary accompanying the Rule (the "Commentary") that the FTC intends to apply the Rule to arrangements that would not necessarily be viewed as traditional non-competes.

What types of arrangements could be deemed to violate the Rule because they "penalize" workers for competing?

The Commentary specifically identifies forfeiture-for-competition clauses and liquidated damages provisions as terms or conditions of employment that penalize workers for competing if they are triggered by post-employment competition. A worker's *voluntary* decision not to compete in order to retain compensation earned from a prior employer is irrelevant to the FTC's analysis of the applicability of the Rule, as the FTC only considers that the worker would experience adverse financial consequences as a direct result of competing. Severance contingent on a worker not competing is also provided as an example of a term that "penalizes" post-employment competition. The Commentary does not address severance subject to an off-set against compensation received by a worker from *any* subsequent employment (rather than being forfeited for competitive employment).

If a non-compete in exchange for severance isn't compliant with the Rule, are "garden leave" arrangements and fixed-term employment contracts permissible?

Yes, BUT it is unclear if "garden leave" arrangements would need to conform precisely to the concept of "garden leave," as discussed in the Commentary. The FTC describes garden leave as an arrangement in which a worker remains employed and continues to receive the same total annual compensation and benefits as they had been receiving (on a pro rata basis), but the worker's access to coworkers and the employer's premises are restricted. This type of arrangement would therefore not be considered a non-compete, because there is no post-employment restriction. The FTC similarly noted that fixed-term employment contracts are arrangements that do not restrict post-employment work.

It is unclear from the Commentary, however, how the FTC would view an arrangement providing a *reduced* level of compensation for the garden leave period, as is sometimes done. As garden leave is a relatively uncommon practice in the U.S. (outside of the financial services industry), and the Commentary on this point is limited, employers may remain at risk of facing challenges from the FTC if they shift to utilizing such arrangements in lieu of non-competes, unless the strict requirements outlined in the Commentary are followed.

How could restrictive covenants other than non-competes potentially fall within the "functions to prevent" prong of the definition of non-compete clause?

While the Rule does not expressly prohibit employers from entering into or enforcing restrictive covenants other than non-competes, the Rule is drafted expansively enough to potentially encompass other types of worker restrictions. The Commentary provides non-disclosure agreements ("NDAs"), training repayment agreements, and non-solicitation agreements as examples of restrictive covenants that do not by their terms prohibit or penalize post-employment work, but that could be drafted in such an overly broad or onerous manner as to function as a non-compete under the Rule. NDAs covering a worker's general knowledge or skills obtained during the employment or service relationship or information that is readily available to other employers or the public, while not expressly prohibiting post-employment work, could essentially "function to prevent" a worker from competing. The FTC noted NDAs that prohibit a worker from disclosing any information that is "usable in" or "relates to" the industry in which the individual works as being problematic under the Rule. Overly broad non-solicitation agreements, no-hire agreements, and certain non-interference agreements could similarly be viewed by the FTC as functional non-competes.

The Rule expressly states that a "term or condition of employment includes, but is not limited to, a contractual term or *workplace policy*, whether written or oral," and therefore employers should keep in mind, for example, that confidentiality or non-disclosure provisions in employee handbooks or certain restrictions on soliciting business could also be challenged under the Rule as potentially overbroad and as constituting functional non-competes.

How will the Rule be enforced and what remedies can the FTC seek against an employer found to have violated the Rule?

The FTC's ability to enforce the Rule is generally limited to an administrative adjudication process if the FTC believes that a person has engaged in an unfair method of competition; however, the FTC can also seek injunctive relief and civil penalties in certain circumstances. The Rule expressly states that it supersedes state laws that either permit a person to engage in conduct that is an unfair method of competition under the Rule (i.e., entering into or enforcing a non-compete) or conflict with the Rule's notice requirement (as discussed below). However, considering that the Rule does not provide individuals with a private right of action and the FTC Act can only be enforced by the FTC, it is unclear how the FTC will manage individual workers' allegations of unenforceable non-competes and what role state courts may continue to play in adjudicating non-compete disputes.

Exceptions to the FTC's Non-Compete Ban

Does the Rule provide any exceptions permitting employers to enter into new non-competes after the Effective Date?

Yes, one. The Rule includes an exception for non-competes entered into with a seller in a sale-of-business context. The Rule requires that such a sale must be a *bona fide* sale of a business entity, a person's ownership interest in a business entity, or all or substantially all of the operating assets of a business entity, without regard to the ownership level or position of the person covered by the non-compete. The Commentary provides that a sale of a business is *bona fide* if it is a sale made in good faith and at arm's-length between two independent parties in which the seller is given a reasonable opportunity to negotiate the terms of such sale.

Can employers still enforce existing non-competes after the Effective Date?

Broadly speaking, no. However, there is a limited exception for non-competes entered into before the Effective Date with workers who fall within the definition of "senior executive" under the Rule (as discussed below). It is important to note, however, that this exception *does not* permit employers to enter into new non-competes with senior executives following the Effective Date. The Rule also includes an exception preserving the enforceability of non-competes for which a cause of action has accrued before the Effective Date, as well as the sale-of-business exception described above.

How narrow is the senior executive exception?

For a worker to qualify as a senior executive, the individual must both meet a minimum annual compensation threshold of at least $151,164 (generally consisting of salary and other nondiscretionary compensation, but excluding fringe benefits) and be in a "policy-making position." The Rule defines a policy-making position as a business entity's president, chief executive officer, or equivalent and any other officer or person with "policy-making authority," which requires the individual to have *final authority* to make policy decisions that control *significant aspects* of the business entity, but expressly excludes individuals whose authority is limited to a subsidiary or affiliate of the business entity and does not extend to the enterprise as a whole.

While the Rule's Effective Date may be put on hold on a nationwide basis as a result of the pending legal proceedings, employers may wish to start evaluating which workers would meet the Rule's definition of senior executive. Once the universe of senior executives is defined, employers may want to ensure that those individuals not already subject to non-competes enter into appropriate non-competes before the Effective Date to satisfy this exception. Whether a worker meets the requirements of being a senior executive will require a fact-intensive inquiry into the nature of the individual's role, responsibilities, authority, and reporting requirements.

How does the Rule's definition of senior executive differ from a public company's "Section 16 officers" or "named executive officers"?

While the Commentary notes that the FTC looked to the rules and regulations of the Securities and Exchange Commission (the "SEC") when crafting the senior executive exception, unfortunately, employers cannot simply apply the exception to individuals deemed to be "officers" or "executive officers" for purposes of SEC reporting requirements. In contrast to individuals identified as officers for purposes of Section 16 of the Securities Exchange Act of 1934 ("Section 16 Officers") (generally a registrant's president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division, or function, or any other officer or person who performs a policy-making function), the Rule's definition of "policy-making position" is likely to encompass a more limited group of workers. The FTC expressly declined to adopt the SEC's phrase "policy-making function," emphasizing that such term is not defined by the SEC and the FTC wants to avoid having employers classify too many workers as senior executives.

For example, while a vice president in charge of a principal business unit, division, or function may constitute a Section 16 Officer, such vice president is unlikely to also constitute a senior executive under the Rule unless that individual's decision-making authority extends to the company as a whole. The Commentary equated heads of subsidiaries and affiliates to "department heads" and noted that the Head of Marketing for an employer would not constitute a senior executive if the individual's authority were limited to marketing decisions, as those decisions would likely not control significant aspects of the employer's business. Similarly, depending on the specific circumstances, it is possible that only a subset of a public company's "named executive officers" for compensation disclosure purposes (generally a registrant's principal executive officer, principal financial officer and the three most highly compensated "executive officers" (defined similarly to Section 16 Officers as described above)) will also qualify as senior executives.

What is the existing cause of action exception and when is a cause of action deemed to have accrued before the Effective Date for purposes of that exception?

The existing cause of action exception preserves the enforceability of non-competes for which a cause of action has accrued before the Effective Date. While the FTC's discussion of this exception is limited, the Commentary provides, as an example, that the exception would be met if an employer were alleging that a worker accepted employment in breach of a non-compete, and such alleged breach occurred before the Effective Date. The exception should provide some comfort to employers concerned that a worker could breach a non-compete before the Effective Date and avoid the consequences once the Rule becomes effective if the employer does not learn of the alleged breach until after the Effective Date. For employers who are currently aware (or become aware) of an alleged breach that occurred before the Effective Date, this exception should alleviate the concern that an employer must file a claim before the Effective Date to preserve its rights.

Is an employer required to notify workers who are not covered by an exception that existing non-competes will no longer be enforceable?

Yes. For workers whose non-competes were entered into before the Effective Date and will no longer be enforceable, the Rule requires that the person or entity that entered into the non-compete must provide "clear and conspicuous notice" (the FTC has provided a model) to the worker *by the Effective Date* to the effect that the worker's non-compete will not and cannot legally be enforced. Employers should be aware of any workers falling within the Rule's exceptions and should identify non-competes entered into with senior executives or in connection with a sale of a business in order to prevent those workers from receiving the notice and avoid inadvertently creating a question as to enforceability.

Looking Ahead

What should employers do now?

Employers still have time to evaluate the impact of the Rule on their non-compete and related restrictive covenant practices (and prepare for the Rule's notice requirement) and assess what, if any, changes may need to be made to comply with the Rule, should the Rule survive the pending legal challenges. Employers should closely monitor any further judicial developments in the pending cases (and any additional lawsuits that may be brought). Whether because of pending or future litigation or other factors, the Rule potentially faces a long and winding road through the judicial process, and any final resolution could be months (or even years) away.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Joel Kurtzberg (partner) at 212.701.3120 or jkurtzberg@cahill.com; Geoffrey E. Liebmann (senior counsel) at 212.701.3313 or gliebmann@cahill.com; Mark Gelman (counsel) at 212.701.3061 or mgelman@cahill.com; or Eric Scher (senior attorney) at 212.701.3984 or escher@cahill.com; or email publicationscommittee@cahill.com.